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Does Countercyclical Economic Policy Matter?

June 24, 1980

Highlights

- **The rational expectations approach to economic theory has gained many proponents and critics since its initial formulation in the early 1960s. The rational expectationists' view on the effectiveness, let alone the desirability, of countercyclical monetary and fiscal policy actions has profound implications for policymakers. In order to promote further understanding and discussion of the concept and its implications, this article briefly describes the rational expectations approach as well as criticisms of it.**
- **The rational expectations school argues that if people, including policymakers, behave in a consistent and predictable manner, then the public will know what policy actions will be taken in any given set of economic circumstances. Thus, rational expectationists conclude that changes in monetary or fiscal policy designed to "fine-tune" the economy will be ineffective at best and counterproductive at worst.**
- **Although not suitable for countercyclical purposes, fiscal and monetary policies remain important tools for causing long-term structural changes in the economy. Stable and credible policies in effect over the long run can direct rational behavior toward desirable goals.**
- **Critics of the rational expectations approach contend that relatively few segments of society have sufficient understanding of the relevant economic forces to behave rationally in a consistent manner. Moreover, many institutional rigidities such as long-term contracts exist which will prevent rapid change in economic behavior despite changes in expectations.**
- **Regardless of the final outcome of the debate, rational expectations theory has one very important lesson: a policymaker attempting to determine the likely outcome of a new policy must consider how the public will perceive it. Thus, the credibility and intentions of government officials take on new significance.**

Dr. Sung Won Son
Senior Vice President and
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Rational Expectations

When economists get together nowadays, an issue likely to generate the hottest argument is the question of the "rational expectations" view of the world. The issue at stake is a profound one: does countercyclical economic policy matter? The basic question is not merely whether one policy is better than another, but whether any countercyclical economic policy is effective. This is no longer an ivory tower debate. It has found its way into the popular financial press where strong opposing opinions are found.

Activist Policies

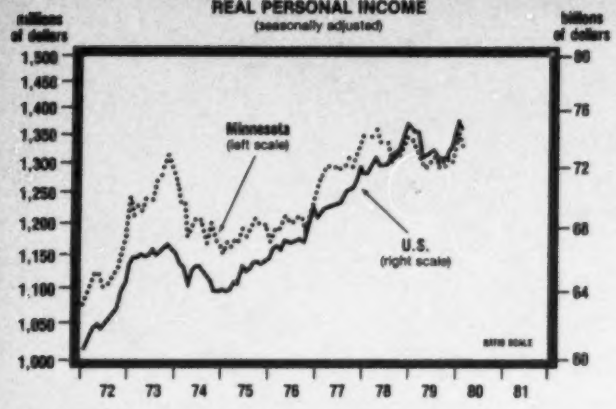
Economic policy in the United States since the New Deal Era of the thirties has been an activist policy — a policy in which the government has continually intervened in the economy to moderate the business cycle and encourage economic growth. This policy was born of the necessities of the Great Depression. It found its theoretical justification in the work of John Maynard Keynes.

The content of this policy has been the use of fiscal and monetary policy to offset instability generated in the private sector of the economy. It has often meant that in a recession the government increases spending or reduces taxes to increase aggregate expenditures. In addition, the government may increase the money supply to reduce interest rates so that business investment will be stimulated.

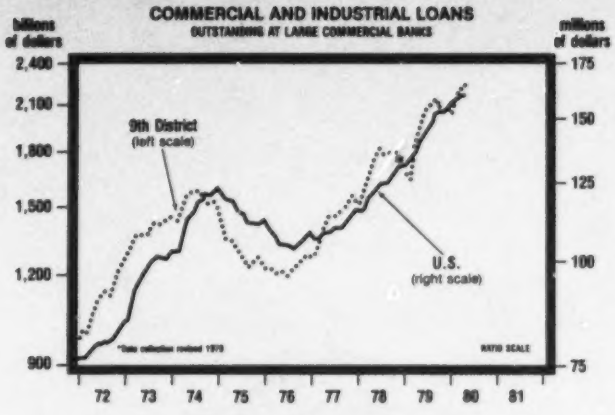
In contrast to activist policies, one can distinguish a series of non-discretionary policies which go under the name of "automatic stabilizers." These policies were introduced during roughly the same period that activist policies became popular. Policies, such as unemployment compensation and progressive income taxes, partially offset the declines in income that occur in recession, and reduce the increases in income

REGIONAL ECONOMIC CONDITIONS

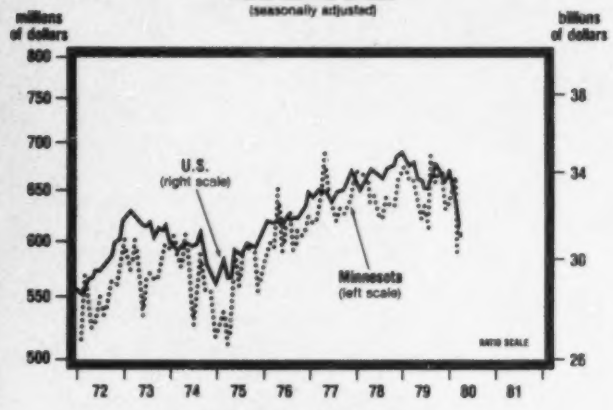
REAL PERSONAL INCOME
(seasonally adjusted)



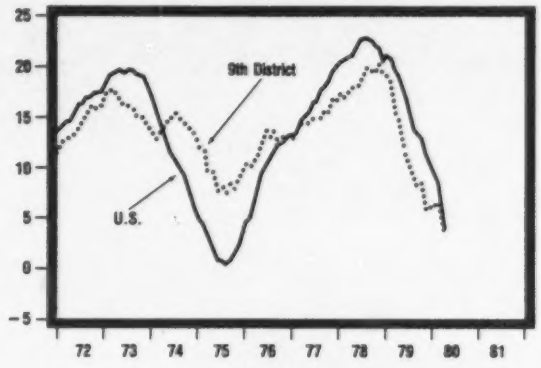
COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS



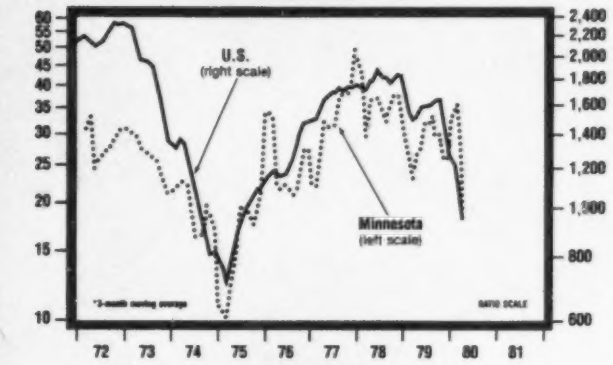
REAL RETAIL SALES
(seasonally adjusted)



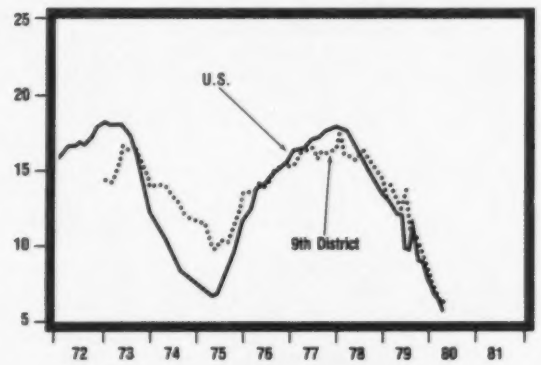
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



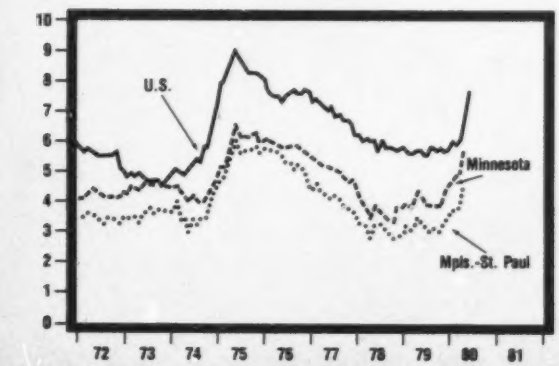
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



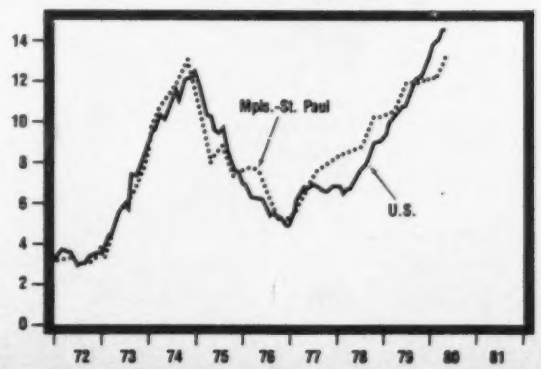
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



that would occur in times of expansion without any discretionary interference of the fiscal or monetary authorities. These two types of policies were both the result of the general attitude that prevailed in the thirties and in the postwar period. This attitude was a desire for the government to do something to deal with current economic problems. The two policies, however, represent two very different approaches to dealing with the same problem.

J.M. Keynes and his critic, Milton Friedman, both agreed that monetary and fiscal policies mattered, though with quite different opinions about their relative salutary influence on the economy. Keynes argued that fiscal policy was the more important of the two major policy instruments. Friedman, on the other hand, argued that fiscal policy was relatively ineffectual in stabilizing economic activity, and that monetary policy had far more reaching consequences for the economy.

Even so, Friedman argued against the use of discretionary monetary policy and for its replacement with a monetary rule of stable growth of the money supply. He felt discretionary policy would affect the economy in the wrong way because of the long lag between the implementation of monetary policies and their effect on the economy. Also, he felt that discretionary policy was too variable to permit a consistently successful policy to be followed. Under these circumstances, Friedman argued that discretionary monetary policy was like playing Russian roulette with the economy. It could never be known whether a particular policy action would have a desired or undesired effect on the economy; a stable policy was more likely to be successful. If money supply growth is fixed at a stable rate of growth, it will slow down the economy when rapid expansion takes place and it will stimulate the economy when the rate of growth slows down. In short, Friedman's monetary rule acts as an automatic stabilizer.

Underlying the Friedman view, and in contrast to that of Keynes, is the belief that the economy is inherently stable and will always return to its long-run growth rate established by real factors such as technology, growth of the labor force and the long-run rate of saving.

Friedman's criticism of activist policy amounted to saying that it is a difficult, but not necessarily an impossible, task to conduct discretionary policy in a manner that will achieve positive results. The criticism that was to be launched by the rational expectationists was much more sweeping: they were to deny the possibility of any successful activist policy.

Rational Expectations

The rational expectations school (RES) argues that if people, including policymakers, behave in a rational (i.e., consistent) manner, then the public, when it recognizes that a particular economic situation is developing, will know that policymakers will take certain policy actions. The public takes these policy actions into account in formulating its economic plans so that when the policy action is actually taken, it will have no effect whatsoever on their behavior.

The strongest assumption made by the rational expectations proponents is that people's expectations about the effect of policy on real factors, such as prices or wages, are not *systematically* incorrect, even in the short run. This line of thought can be applied to the case of the formation of price expectations. Because firms' profits and households' real wages depend, in part, on realized prices, people have a strong incentive to form their expectations as accurately as possible about future prices. They will do this by taking into account all the information available to them, including the available information about the probable course of monetary and fiscal policy. If expectations are rational in this sense, then systematic and therefore predictable activist policies can have no predictable real effects, since they already have been taken into account by individuals in their economic decisions.

Let us apply this to monetary policy. If the Federal Reserve System announces that it will increase the money supply over the next few months, and if everyone believes this is so, and the Fed actually increases the money stock as it has promised, then in an economy where expectations are formed rationally, everyone will react to this information by increasing their price and wage expectations to take account of the change in Federal Reserve policy. Workers will raise their wage demands to take account of the expected change in the rate of inflation; producers will take account of the expected higher wage demands in setting their future prices and production demands; lenders will take account of the higher expected rate of inflation in setting their interest rates; in short, everyone who might possibly be affected by a change in prices will have adjusted their individual economic plans to the expected rise in prices.

If everyone forecasts correctly the wage and price consequences of the Federal Reserve's actions, the effect of the increase in the money supply will be to increase prices, causing inflation, without any change in the real wage, expected real profits, employment or output. The result would be similar to a case where the Federal Reserve Board tells everyone to add an extra zero to all quantities denominated in dollars. This will increase prices and the nominal money supply ten times, but this change will be transparent and everyone will go on behaving

as before. Only if people are "tricked" into believing they are richer or poorer, will this change in the money supply and prices have any real effects.

Furthermore, it is not necessary that everyone's revision of expectations induced by an anticipated policy change be correct, although on the *average* it is expected they will be. Workers may, by chance, underestimate future inflation and therefore underestimate the change in real wages that their wage bargains will yield. Similarly, employers may initially interpret the rise in prices as the result of increased demand for their product and increase their work force. Expecting higher real wages, workers may increase their offer of labor services. These actions will result in a rise in output and employment.

Employment and output will continue to rise until the difference between expected and actual rates of inflation are eliminated. Eventually, as prices rise, workers will increase their wage demands to compensate for the effect of the inflation, producers' costs will rise, and their profits will fall resulting in a cutback in output and employment.

In the rational expectations view, then, it is only when the economic actors make errors in their expectations that real consequences flow for the economy. However, the RES is quick to point out that these errors in expectations may be positive or negative so that the direction of the outcome of any particular policy cannot be known ahead of time. Activist policy therefore depends on two assumptions according to the RES: uncertainty about the consequences of future policy changes, and slow rates of adjustment of actual wages and prices to expected changes in wages and prices.

Expectations, of course, play an important role even in traditional economic analysis. The idea that individual behavior depends on anticipated events is not a monopoly of the RES. Rather, the unique insight of the RES is that anticipated events, including policy actions, cause people acting in their own interest to change their behavior in such a manner as to render the final impact of economic policy unpredictable.

Applied to the control of inflation, the rational expectationist argues that if the Federal Reserve announces a sharp decline in the rate of growth of the money supply, and the public really believes this, then inflation will deaccelerate immediately, and it will achieve this costlessly. Furthermore, unless the economic authorities are capable of instituting economic policies in such a manner as to always surprise people, the best way in which to exploit the rationality of expectations is to provide a regime of predictable policies. Hence, the RES prefers a monetary growth rule and other nondiscretionary policy prescriptions to activist policies attempting to fine-tune the economy.

The rational expectations school is sometimes interpreted to imply that any governmental economic policy is ineffective. This is incorrect. They say that only a certain type of government policy is ineffectual, namely one triggered by feedback from the current state of the economy. For example, they will argue that an investment tax credit, introduced during periods of weak economic activity to increase aggregate demand, will not be effective. Rather, it will already be taken into account in the investment plans of businesses. However, an investment tax credit introduced with the expectation that it will be permanent could alter the rate of business investment permanently, and affect the rate of growth of the economy. In less formal terms, the RES is arguing for economic policies that affect the structure of the economic environment and the long-run values of real economic variables.

Criticism of Rational Expectations

At this point in the discussion, you might have some reservations about the capacity the RES assigns to the individual. While it is flattering to say that individuals are rational and cannot be "fooled", at least systematically, it does seem to stretch the capacity of informed rational individuals to absorb, process and act upon all the relevant available information.

RES requires the individual to know more about the economy than seems realistically possible, and to have at least as much information as policymakers have. Even large economic organizations have difficulty gathering and processing all the information relevant to a particular economic decision. Furthermore, there is no guarantee that rational individuals will form expectations distributed about the same average value. As has been pointed out by Richard Muth, the father of rational expectations, the formation of an economic expectation is similar to making an economic forecast. Since economists are not agreed as to which models will yield the "best" forecast, is it reasonable to assume that there will be any greater unanimity among the people at large?

Furthermore, rational expectations assumes that after the relevant information has been gathered and processed and expectations have been formed, decisions based on these expectations can be acted upon immediately and without cost. This, of course, is not the case. It is not possible to alter productive processes immediately, nor is it possible to renegotiate all contracts concerning prices and wages, simply because expectations have changed. As long as economic agents cannot adjust rapidly and costlessly to changed expectations, the results are similar to the case where they are "surprised". During this interim period, when they try to adjust

to their expectation, there is scope for an activist policy to have real effects.

Most of the discussion of rational expectations has focused on aggregate economic activity, employment, and demand. An equally important issue is the *composition* of output. Here, even the RES admits activist policies may affect the commodity composition of output and the distribution of income. Augmenting accelerated depreciation allowances, for example, will affect the composition of savings and investment in the short-run and the rate of growth in the long-run.

The Bottom Line

A good deal of economic knowledge consists of putting old wine into new bottles. Rational expectations, by making a group of extreme assumptions, has forcefully called to our attention some fundamental economic truths.

The basic assumption that expectations are rational and that individuals, acting in their own interest, try to anticipate the impact of expected policy changes on wages, prices, and patterns of supply and demand, is common sense. The argument that they do this exhausting all available information and share the same basic concept of the interrelationship of the economic variables is clearly an overstatement made in the interests of academic rigor but at variance with the current state of the world.

The presence of information costs and obstacles to the immediate and costless adjustment of prices, production, financial variables and wages to conform to individual's expectations of the future implies that the rational expectations conclusion that an activist policy will have *no* effect on the economy is invalid. The RES does, however, have a valid point that individuals attempting to act in their own interest based on their expectations of future policy decisions will tend to *partially* offset the efficiency of these policies.

A curiosity of the RES is that only if their view is false, can one argue that activist policymakers in the past have had a destabilizing influence on the economy in the macroeconomic realm. If the RES position were true, activist policies would have had no real effect on the economy. It is because of this last consideration that leading exponents of imposing a monetary growth rule have been slow to embrace a rational expectation view of the world.

The emerging view is that activist policies have a role to play in achieving short-run stabilization, but work less efficiently and predictably than was customarily believed before, because the behavior of intelligent human beings is not invariant but takes into account the policies being followed by the economic authorities. Moreover, long-run policies will be more effective the more stable and *credible* they are. Applied to today's problem of inflation, the effectiveness of the Federal Reserve's actions will depend in large measure on whether they can convince the public of their ability to stick to their policy of a slower rate of monetary growth.